

§ 1.1368-4

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is a distribution from S's AAA and is treated by the shareholders as a return of capital or gain from the sale or exchange of property, as appropriate, under § 1.1368-1(d)(1). S's AAA, as of December 31, 1996, equals \$130 (\$210-\$80).

Example 8. Distributions in excess of the AAA.

(i) On January 1, 1995, Corporation S has \$40 of earnings and profits and a balance in the AAA of \$100. S has two shareholders, E and F, each of whom own 50 shares of S's stock. For 1995, S has taxable income of \$50, which increases the AAA to \$150 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes \$60 to each shareholder. On September 1, 1995, S distributes \$30 to each shareholder. S does not make the election under section 1368(e)(3) and § 1.1368-1(f)(2) to distribute its earnings and profits before its AAA.

(ii) The sum of the distributions exceed S's AAA. Therefore, under § 1.1368-2(b), a portion of S's \$150 balance in the AAA as of December 31, 1995, is allocated to each of the February 1 and September 1 distributions based on the respective sizes of the distributions. Accordingly, S must allocate \$100 (\$150 (AAA) × (\$120 (February 1 distribution) / \$180 (the sum of the distributions))) of the AAA to the February 1 distribution, and \$50 (\$150 × (\$60 / \$180)) to the September 1 distribution. The portions of the distributions to which the AAA is allocated are treated by the shareholder as a return of capital or gain from the sale or exchange of property, as appropriate. The remainder of the two distributions is treated as a dividend to the extent that it does not exceed S's earnings and profits. E and F must each report \$10 of dividend income for the February 1 distribution. For the September 1 distribution, E and F must each report \$5 of dividend income.

Example 9. Ordinary and redemption distributions in the same taxable year. (i) On January 1, 1995, Corporation S, an S corporation, has \$20 of earnings and profits and a balance in the AAA of \$10. S has two shareholders, G and H, each of whom owns 50 shares of S's stock. For 1995, S has taxable income of \$16, which increases the AAA to \$26 as of December 31, 1995 (before taking into account distributions made during 1995). On February 1, 1995, S distributes \$10 to each shareholder. On December 31, 1995, S redeems for \$13 all of shareholder G's stock in a redemption that is treated as a sale or exchange under section 302(a).

(ii) The sum of the ordinary distributions does not exceed S's AAA. Therefore, S must reduce the \$26 balance in the AAA by \$20 for the February 1 ordinary distribution. The portions of the distribution by which the AAA is reduced are treated by the shareholders as a return of capital or gain from the sale or exchange of property. S must adjust the remaining AAA, \$6, in an amount

equal to the ratable share of the remaining AAA attributable to the redeemed stock, or \$3 (50% × \$6).

(iii) S also must adjust the earnings and profits of \$20 in an amount equal to the ratable share of the earnings and profits attributable to the redeemed stock. Therefore, S adjusts the earnings and profits by \$10 (50% × \$20), the ratable share of the earnings and profits attributable to the redeemed stock.

[T.D. 8508, 59 FR 22, Jan. 3, 1994; 59 FR 10675, Mar. 7, 1994, as amended by T.D. 8852, 64 FR 71650, Dec. 22, 1999]

§ 1.1368-4 Effective date and transition rule.

Except for §§ 1.1368-1(e)(2), 1.1368-2(a)(5), and 1.1368-3 *Example 2*, *Example 4*, and *Example 5*, §§ 1.1368-1, 1.1368-2, and 1.1368-3 apply to taxable years of the corporation beginning on or after January 1, 1994. Section 1.1368-1(e)(2), § 1.1368-2(a)(5), and § 1.1368-3 *Example 2*, *Example 4*, and *Example 5* apply only to taxable years of the corporation beginning on or after August 18, 1998. For taxable years beginning before January 1, 1994, and taxable years beginning on or after January 1, 1997, and before August 18, 1998, the treatment of distributions by an S corporation to its shareholders must be determined in a reasonable manner, taking into account the statute and legislative history. Except with regard to the deemed dividend rule under § 1.1368-1(f)(3), § 1.1368-1(e)(2), § 1.1368-2(a)(5), and § 1.1368-3 *Example 2*, *Example 4*, and *Example 5*, return positions consistent with §§ 1.1368-1, 1.1368-2, and 1.1368-3 are reasonable for taxable years beginning before January 1, 1994. Return positions consistent with §§ 1.1368-1(e)(2), 1.1368-2(a)(5), and 1.1368-3 *Example 2*, *Example 4*, and *Example 5* are reasonable for taxable years beginning on or after January 1, 1997, and before August 18, 1998.

[T.D. 8852, 64 FR 71651, Dec. 22, 1999]

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[T.D. 8579, 59 FR 66463, Dec. 27, 1994]

§ 1.1374-1 General rules and definitions.

(a) *Computation of tax.* The tax imposed on the income of an S corporation by section 1374(a) for any taxable year during the recognition period is computed as follows—

(1) Step One: Determine the net recognized built-in gain of the corporation for the taxable year under section 1374(d)(2) and § 1.1374-2;

(2) Step Two: Reduce the net recognized built-in gain (but not below zero) by any net operating loss and capital loss carryforward allowed under section 1374(b)(2) and § 1.1374-5;

(3) Step Three: Compute a tentative tax by applying the rate of tax determined under section 1374(b)(1) for the taxable year to the amount determined under paragraph (a)(2) of this section;

(4) Step Four: Compute the final tax by reducing the tentative tax (but not below zero) by any credit allowed under section 1374(b)(3) and § 1.1374-6.

(b) *Anti-trafficking rules.* If section 382, 383, or 384 would have applied to limit the use of a corporation's recognized built-in loss or section 1374 attributes at the beginning of the first day of the recognition period if the corporation had remained a C corporation, these sections apply to limit their use in determining the S corporation's pre-limitation amount, taxable income limitation, net unrealized built-in gain